

the empowerment zone in a trade or business of the employer.

(3) *Examples.* This paragraph (b) may be illustrated by the following examples. In each example, the following assumptions apply. The employees satisfy the abode requirement at all relevant times and all services performed by the employees for their employer are performed in a trade or business of the employer. The employees are not precluded from being qualified zone employees by section 1396(d)(2) (certain employees ineligible). No portion of the employees' wages is precluded from being qualified zone wages by section 1396(c)(2) (only first \$15,000 of wages taken into account) or section 1396(c)(3) (coordination with targeted jobs credit and work opportunity credit). The examples are as follows:

*Example 1.* (i) Employer X has a weekly pay period for all its employees. Employee A works for X throughout 1997. During each of the first 20 weekly pay periods in 1997, substantially all of A's work for X is performed within the empowerment zone in which A resides. A also works in the zone at various times during the rest of the year, but there is no other pay period in which substantially all of A's work for X is performed within the empowerment zone. Employer X uses the pay period method.

(ii) For each of the first 20 pay periods of 1997, A is a qualified zone employee, all of A's wages from X are qualified zone wages, and X may claim the empowerment zone employment credit with respect to those wages. X cannot claim the credit with respect to any of A's wages for the rest of 1997.

*Example 2.* (i) Employer Y has a weekly pay period for its factory workers and a bi-weekly pay period for its office workers. Employee B works for Y in various factories and Employee C works for Y in various offices. Employer Y uses the pay period method.

(ii) Y must use B's weekly pay periods to determine the periods (if any) in which B is a qualified zone employee. Y may claim the empowerment zone employment credit with respect to B's wages only for the weekly pay periods for which B is a qualified zone employee, because those are B's only wages that are qualified zone wages. Y must use C's bi-weekly pay periods to determine the periods (if any) in which C is a qualified zone employee. Y may claim the credit with respect to C's wages only for the bi-weekly pay periods for which C is a qualified zone employee, because those are C's only wages that are qualified zone wages.

*Example 3.* (i) Employees D and E work for Employer Z throughout 1997. Although some

of D's work for Z in 1997 is performed outside the empowerment zone in which D resides, substantially all of it is performed within that empowerment zone. E's work for Z is performed within the empowerment zone in which E resides for several weeks of 1997 but outside the zone for the rest of the year so that, viewed on an annual basis, E's work is not substantially all performed within the empowerment zone. Employer Z uses the calendar year method.

(ii) D is a qualified zone employee for the entire year, all of D's 1997 wages from Z are qualified zone wages, and Z may claim the empowerment zone employment credit with respect to all of those wages, including the portion attributable to work outside the zone. Under the calendar year method, E is not a qualified zone employee for any part of 1997, none of E's 1997 wages are qualified zone wages, and Z cannot claim any empowerment zone employment credit with respect to E's wages for 1997. Z cannot use the calendar year method for D and the pay period method for E because Z must use the same method for all employees. For 1998, however, Z can switch to the pay period method for E if Z also switches to the pay period method for D and all of Z's other employees.

(c) *Effective date.* This section applies with respect to wages paid or incurred on or after December 21, 1994.

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#### § 1.1397E-1 Qualified zone academy bonds.

(a) *In general—(1) Overview.* In general, a qualified zone academy bond (QZAB or QZABs) is a taxable bond issued by a state or local government the proceeds of which are used to improve certain eligible public schools. An eligible taxpayer that holds a QZAB generally is allowed annual Federal income tax credits in lieu of periodic interest payments. These credits compensate the eligible taxpayer for lending money to the issuer and function as payments of interest on the bond. Accordingly, this section generally treats the allowance of a credit as if it were a payment of interest on the bond. This section also provides other rules for QZABs, including rules governing the credit rate, the private business contribution requirement, the maximum term, use and expenditure of proceeds, remedial actions, eligible issuers, arbitrage investment restrictions, and information reporting.

(2) *Certain definitions—(i) In general.* For purposes of this section, except as

otherwise provided in this section, the following definitions apply: the definitions set forth in this section; the definitions used for general tax-exempt bond purposes in § 1.150-1; and the definitions used for purposes of the arbitrage investment restrictions on tax-exempt bonds in § 1.148-1(b).

(ii) *Applicable definition of proceeds*—(A) *Use and expenditure provisions.* Except as provided in paragraphs (a)(2)(ii)(B) and (a)(2)(ii)(C) of this section, for purposes of all applicable requirements regarding use and expenditure of proceeds of QZABs under section 1397E and this section, “proceeds” means “sale proceeds,” as defined in § 1.148-1(b), plus “investment proceeds,” as defined in § 1.148-1(b).

(B) *Private business contribution requirement.* For purposes of the private business contribution requirement of section 1397E(d)(2), “proceeds” means “sale proceeds,” as defined in § 1.148-1(b).

(C) *Arbitrage investment restrictions.* For purposes of the scope of application of the arbitrage investment restrictions under section 1397E(g) and paragraph (i) of this section, “proceeds” generally means gross proceeds, as defined in § 1.148-1(b). In addition, in applying the arbitrage investment restrictions under paragraph (i) of this section and under section 148, the various applicable definitions of the various types of proceeds of tax-exempt bonds under § 1.148-1(b) shall apply.

(b) *Credit rate.* The Secretary shall determine monthly (or more often as deemed necessary by the Secretary) the credit rate the Secretary estimates will generally permit the issuance of a qualified zone academy bond without discount and without interest cost to the issuer. The manner for ascertaining the credit rate for a qualified zone academy bond as determined by the Secretary shall be set forth in procedures, notices, forms, or instructions prescribed by the Commissioner.

(c) *Private business contribution requirement*—(1) *Reasonable discount rate.* To determine the present value (as of the issue date) of qualified contributions from private entities under section 1397E(d)(2), the issuer must use a reasonable discount rate. The credit rate determined under paragraph (b) of

this section is a reasonable discount rate.

(2) *Definition of private entities.* For purposes of section 1397E(d)(2)(A), the term *private entities* includes any person (as defined in section 7701(a)) other than the United States, a State or local government, or any agency or instrumentality thereof or related party with respect thereto. To determine whether a person is related to the United States or a State or local government under this paragraph (c)(2), rules similar to those for determining whether a person is a related party under § 1.150-1(b) shall apply (treating the United States as a governmental unit for purposes of § 1.150-1(b)).

(3) *Qualified contribution.* For purposes of section 1397E(d)(2)(A), the term *qualified contribution* means any contribution (of a type and quality acceptable to the eligible local education agency) of any property or service described in section 1397E(d)(2)(B)(i), (ii), (iii), (iv) or (v). In addition, cash received with respect to a qualified zone academy from a private entity (other than cash received indirectly from a person that is not a private entity as part of a plan to avoid the requirements of section 1397E) constitutes a qualified contribution if it is to be used to purchase any property or service described in section 1397E(d)(2)(B)(i), (ii), (iii), (iv) or (v). Services of employees of the eligible local education agency do not constitute qualified contributions.

(d) *Maximum term.* The maximum term for a QZAB is determined under section 1397E(d)(3) by using a discount rate equal to 110 percent of the long-term adjusted applicable Federal rate (AFR), compounded semi-annually, for the month in which the bond is sold. The Internal Revenue Service publishes this figure each month in a revenue ruling that is published in the Internal Revenue Bulletin. See § 601.601(d)(2)(ii)(b) of this chapter. A bond is sold on the sale date, as defined in § 1.150-1(c)(6), which is the first day on which there is a binding contract in writing for the sale or exchange of the bond.

(e) *Tax credit*—(1) *Eligible taxpayer.* An eligible taxpayer (within the meaning of section 1397E(d)(6)) that holds a

qualified zone academy bond on a credit allowance date is allowed a tax credit against the Federal income tax imposed on the taxpayer for the taxable year that includes the credit allowance date. The amount of the credit is equal to the product of the credit rate and the outstanding principal amount of the bond on the credit allowance date. The credit is subject to a limitation based on the eligible taxpayer's income tax liability. See section 1397E(c).

(2) *Ineligible taxpayer.* A taxpayer that is not an eligible taxpayer is not allowed a credit.

(f) *Treatment of the allowance of the credit as a payment of interest—(1) General rule.* The holder of a qualified zone academy bond must treat the bond as if it pays qualified stated interest (within the meaning of § 1.1273-1(c)) on each credit allowance date. The amount of the deemed payment of interest on each credit allowance date is equal to the product of the credit rate and the outstanding principal amount of the bond on that date. Thus, for example, if the holder uses an accrual method of accounting, the holder must accrue as interest income the amount of the credit over the one-year accrual period that ends on the credit allowance date.

(2) *Adjustment if the holder cannot use the credit to offset a tax liability.* If a holder holds a qualified zone academy bond on the credit allowance date but cannot use all or a portion of the credit to reduce its income tax liability (for example, because the holder is not an eligible taxpayer or because the limitation in section 1397E(c) applies), the holder is allowed a deduction for the taxable year that includes the credit allowance date (or, at the option of the holder, the next succeeding taxable year). The amount of the deduction is equal to the amount of the unused credit deemed paid on the credit allowance date.

(g) *Not a tax-exempt obligation.* A qualified zone academy bond is not an obligation the interest on which is excluded from gross income under section 103(a).

(h) *Use of proceeds—(1) In general.* Section 1397E(d)(1) provides that a bond issued as part of an issue is a QZAB only if, among other requirements, at least 95 percent of the proceeds of the

issue are to be used for a qualified purpose with respect to a qualified zone academy established by an eligible local education agency (as defined in section 1397E(d)(4)(B)), and the issue meets the requirements of section 1397E(f) and (g). Section 1397E(d)(5) defines *qualified purpose*, with respect to any qualified zone academy, as rehabilitating or repairing the public school facility in which such academy is established, providing equipment for use at such academy, developing course materials for education to be provided at such academy, and training teachers and other school personnel in such academy. Section 1397E(d)(4)(A) defines *qualified zone academy* as any public school (or academic program within a public school) that is established by and operated under the supervision of an eligible local education agency to provide education or training below the postsecondary level and that meets the requirements of section 1397E(d)(4)(A)(i), (ii), (iii) and (iv).

(2) *Use of proceeds requirements.* An issue meets the requirements of sections 1397E (d)(1)(A) and (f) only if—

(i) The issuer reasonably expects, as of the issue date of the issue, that—

(A) At least 95 percent of the proceeds from the sale of the issue are to be spent for qualified purposes with respect to qualified zone academies within the 5-year period beginning on the issue date of the QZAB;

(B) A binding commitment with a third party to spend at least 10 percent of the proceeds from the sale of the issue will be incurred within the 6-month period beginning on the issue date of the QZAB;

(C) At least 95 percent of the proceeds from the sale of the issue will be spent for qualified purposes with respect to a qualified zone academy with due diligence (with due diligence measured by the reasonableness standard under § 1.148-1(b)); and

(D) At least 95 percent of the proceeds of the issue will be used for qualified purposes with respect to a qualified zone academy for the entire term of the issue (without regard to any redemption provision); and

(ii) Except as otherwise provided in paragraph (h)(8) of this section, at least 95 percent of the proceeds of the issue

are actually used for qualified purposes with respect to a qualified academy for the entire term of the issue (without regard to any redemption provision).

(3) *Extension of 5-year period.* The Commissioner may extend the period described in paragraph (h)(2)(i)(A) of this section if the issuer, prior to the end of such period, submits a private ruling request, and establishes to the satisfaction of the Commissioner that—

(i) The failure to satisfy the 5-year spending requirement is due to reasonable cause; and

(ii) The expenditure of at least 95 percent of the proceeds from the sale of the issue for a qualified purpose with respect to a qualified zone academy will continue to proceed with due diligence.

(4) *Unspent proceeds.* For purposes of paragraphs (h)(2)(i)(D) and (h)(2)(ii) of this section, during the period described in paragraph (h)(2)(i)(A) of this section, including any extension under paragraph (h)(3) of this section, unspent proceeds are treated as used for a qualified purpose with respect to a qualified zone academy if the issuer reasonably expects to proceed with due diligence to spend those proceeds for a qualified purpose with respect to a qualified zone academy during that period.

(5) *Proceeds spent for rehabilitation, repair or equipment—*(i) *In general.* Under section 1397E(d)(5)(A) the term *qualified purpose* with respect to any qualified zone academy includes rehabilitating or repairing the public school facility in which such academy is established. For this purpose, in determining whether proceeds are spent for rehabilitation, rules similar to those under section 47(c) (other than sections 47(c)(1)(B) and 47(c)(2)(B)(iv)) shall apply. Under section 1397E(d)(5)(B) the term *qualified purpose* also includes providing equipment for use at such academy. If proceeds of an issue are spent for a purpose described in section 1397E(d)(5)(A) or (B) with respect to a qualified zone academy, then those proceeds are treated as used for a qualified purpose with respect to the academy during any period after such expenditure that—

(A) The property financed with those proceeds is used for the purposes of the academy; and

(B) The academy maintains its status as a qualified zone academy under section 1397E(d)(4).

(ii) *Retirement from service.* The retirement from service of financed property due to normal wear or obsolescence does not cause the property to fail to be used for a qualified purpose with respect to a qualified zone academy.

(6) *Proceeds spent to develop course materials or train teachers.* Section 1397E(d)(5)(C) and (D) provides that the term *qualified purpose* with respect to any qualified zone academy includes developing course materials for education to be provided at such academy, and training teachers and other school personnel in such academy. If proceeds of an issue are spent for a purpose described in section 1397E(d)(5)(C) or (D) with respect to a qualified zone academy, then those proceeds are treated as used for a qualified purpose with respect to the academy during any period after such expenditure.

(7) *Special rule for determining status as qualified zone academy.* Section 1397E(d)(4)(A)(iv) provides that a public school (or academic program within a public school) is a qualified zone academy only if, among other requirements, the public school is located in an empowerment zone or enterprise community (as defined in section 1393), or there is a reasonable expectation (as of the issue date of the issue) that at least 35 percent of the students attending the school or participating in the program (as the case may be) will be eligible for free or reduced-cost lunches under the school lunch program established under the Richard B. Russell National School Lunch Act. For purposes of determining whether an issue complies with section 1397E(d)(4)(A)(iv)—

(i) A public school is treated as located in an empowerment zone or enterprise community for the entire term of the issue if the public school is located in an empowerment zone or enterprise community on the issue date of the issue; and

(ii) The determination of whether there is a reasonable expectation (as of the issue date of the issue) that at

least 35 percent of the students attending the school or participating in the program (as the case may be) will be eligible for free or reduced-cost lunches under the school lunch program established under the Richard B. Russell National School Lunch Act is based on expectations regarding the one-year period following the issue date.

(8) *Remedial actions*—(i) *General rule.* If less than 95 percent of the proceeds of an issue are properly used (as determined under paragraph (h)(8)(ii)(D) of this section), the issue will be treated as meeting the requirements of section 1397E(d)(1)(A) if the issue met the requirements of paragraph (h)(2)(i) of this section and a remedial action is taken under paragraph (h)(8)(ii) or (iii) of this section.

(ii) *Redemption or defeasance*—(A) *In general.* A remedial action is taken under this paragraph (h)(8)(ii) if the requirements of paragraphs (h)(8)(ii)(B) and (C) of this section are met.

(B) *Retirement of nonqualified bonds*—(1) *In general.* The requirements of this paragraph (h)(8)(ii)(B) are met if—

(i) All of the nonqualified bonds of the issue (as determined under § 1.142-2(e)) are redeemed within 90 days after the date on which the failure to properly use proceeds occurs; or

(ii) To the extent proceeds of the issue that have been actually spent for a qualified purpose with respect to a qualified zone academy, if any nonqualified bonds of the issue are not redeemed within 90 days after the date on which the failure to properly use such proceeds occurs (the unredeemed nonqualified bonds), a defeasance escrow is established for the unredeemed nonqualified bonds within 90 days after the date on which the failure to properly use proceeds occurs.

(2) *Special rule for dispositions for cash.* If the failure to properly use proceeds occurs because of a disposition of financed property described in section 1397E(d)(5)(A) or (B) and the consideration for the disposition is exclusively cash, the requirements of this paragraph (h)(8)(ii)(B) are met if all of the disposition proceeds (as defined in paragraph (h)(8)(iv) of this section) are used within 90 days after the date of the disposition to redeem, or establish a defeasance escrow for, the non-

qualified bonds (as determined under § 1.142-2(e)).

(3) *Definition of defeasance escrow.* For purposes of this section, a defeasance escrow is an irrevocable escrow established to retire nonqualified bonds on the earliest call date after the date on which the failure to properly use proceeds occurs in an amount that is sufficient to retire nonqualified bonds on that call date. At least 90 percent of the weighted average amount in a defeasance escrow must be invested in investments (as defined in § 1.148-1(b)), except that no amount in a defeasance escrow may be invested in any investment the obligor (or any person that is a related party with respect to the obligor within the meaning of § 1.150-1(b)) of which is a user of proceeds of the bonds. All purchases or sales of an investment in a defeasance escrow must be made at the fair market value of the investment within the meaning of § 1.148-5(d)(6).

(C) *Additional rules*—(1) *Limitation on source of funding.* Proceeds of an issue of QZABs (other than unspent proceeds of the issue for which the failure to properly use proceeds occurs) must not be used to redeem or defease nonqualified bonds under paragraph (h)(8)(ii)(B) of this section.

(2) *Rebate requirement.* The issuer must pay to the United States, at the same time and in the same manner as rebate amounts are required to be paid under § 1.148-3 (or at such other time or in such other manner as the Commissioner may prescribe), any investment earnings on amounts in a defeasance escrow established under paragraph (h)(8)(ii)(B) of this section that are in excess of the yield on the issue of QZABs with respect to which the defeasance escrow was established. For this purpose, the first computation period begins on the date on which the defeasance escrow is established.

(3) *Notice of defeasance.* The issuer must provide written notice to the Commissioner, at the place designated in § 1.150-5(a), of the establishment of the defeasance escrow within 90 days of the date the defeasance escrow is established.

(D) *When a failure to properly use proceeds occurs*—(1) *Unspent proceeds.* For

unspent proceeds, a failure to properly use proceeds occurs on the earliest of—

(i) The first date on which the public school (or academic program within the public school) fails to constitute a qualified zone academy;

(ii) The first date on which the issuer fails to have a reasonable expectation to proceed with due diligence to spend at least 95 percent of the proceeds of the issue for a qualified purpose with respect to a qualified zone academy; or

(iii) The last day of the period described in paragraph (h)(2)(i)(A) of this section, including any extension, if less than 95 percent of the proceeds of the issue are actually spent for a qualified purpose with respect to a qualified zone academy.

(2) *Proceeds spent for rehabilitation, repair or equipment.* For proceeds that have been spent for a purpose described in section 1397E(d)(5)(A) or (B) with respect to a qualified zone academy, a failure to properly use proceeds occurs on the earlier of—

(i) The first date on which the public school (or academic program within the public school) fails to constitute a qualified zone academy; and

(ii) The first date on which an action is taken that causes the issuer to fail actually to use at least 95 percent of the proceeds of the issue for a qualified purpose with respect to a qualified zone academy.

(3) *Proceeds spent for course materials or training.* If proceeds have been spent for a purpose described in section 1397E(d)(5)(C) or (D) with respect to a qualified zone academy, no event subsequent to such expenditure shall constitute a failure to properly use such proceeds.

(iii) *Alternative use of disposition proceeds.* A remedial action is taken under this paragraph (h)(8)(iii) if all of the requirements of paragraphs (h)(8)(iii)(A) through (D) of this section are met—

(A) The failure to properly use proceeds (as determined under paragraph (h)(8)(ii)(D) of this section) is a disposition of financed property described in section 1397E(d)(5)(A) or (B) and the consideration for the disposition is exclusively cash;

(B) The issuer reasonably expects as of the date of the disposition that—

(1) All of the disposition proceeds will be spent within the two-year period beginning with the date of the disposition for a qualified purpose with respect to a qualified zone academy; or

(2) To the extent not expected to be so spent, the disposition proceeds will be used within 90 days after the date of the disposition to redeem or defease bonds in a manner that meets the requirements of paragraph (h)(8)(ii) of this section;

(C) The disposition proceeds are treated as proceeds for purposes of section 1397E; and

(D) If all of the disposition proceeds are not actually used in the manner described in paragraph (h)(8)(iii)(B) of this section, the remainder of such amounts are used within 90 days after the end of the period described in paragraph (h)(8)(iii)(B)(1) of this section for a remedial action that meets the requirements of paragraph (h)(8)(ii) of this section.

(iv) *Definition of disposition proceeds and allocation among multiple funding sources.* For purposes of this paragraph (h)(8), *disposition proceeds* means disposition proceeds, as defined in § 1.141-12(c)(1), plus amounts derived from investing disposition proceeds. If property has been financed with an issue of QZABs and one or more other funding sources, any disposition proceeds from that property are allocated to the issue under the principles of § 1.141-12(c)(3).

(9) *Payment of principal, interest or redemption price—(i) In general.* Except as provided in paragraphs (h)(9)(ii) and (h)(9)(iii) of this section, the use of proceeds of a bond to pay principal, interest, or redemption price of the bond or another bond is not a qualified purpose within the meaning of section 1397E(d)(5).

(ii) *Exception for certain eligible reimbursements of interim refinancings.* The use of proceeds of a bond (the refinancing bond) to pay principal, interest, or redemption price of another bond (the prior bond) is a qualified purpose within the meaning of section 1397E(d)(5) to the extent that—

(A) The prior bond was not a QZAB (and, in the case of a series of refinancings, no earlier bond in the series was a QZAB);

(B) The proceeds of the prior bond (or the original bond in the case of a series of refinancings, as applicable) were spent for a qualified purpose under section 1397E(d)(5) with respect to a qualified zone academy (the original expenditure); and

(C) The issuer makes a valid reimbursement allocation to allocate the proceeds of the refinancing bond to the payment of the original expenditure (the reimbursement allocation), which allocation satisfies the requirements for reimbursements under paragraph (h)(10) of this section. For purposes of applying the rules for reimbursement, a refinancing bond which otherwise meets the requirements of this paragraph (h)(9)(ii) is eligible for reimbursement and is not treated as a disqualified refunding under § 1.150-2(g).

(iii) *Reissuance of a QZAB.* For purposes of determining whether the establishing of a defeasance escrow under paragraph (h)(8)(ii)(B)(I)(ii) of this section results in an exchange under § 1.1001-1(a), the QZAB is treated as a tax-exempt bond under § 1.1001-3(e)(5)(ii)(B)(I).

(10) *Reimbursement.* An expenditure for a qualified purpose may be reimbursed with proceeds of a QZAB. For this purpose, rules similar to those on reimbursement of expenditures in § 1.142-4(b) and § 1.150-2 shall apply. In applying these reimbursement rules, expenditures eligible for reimbursement under § 1.150-2(d)(3) shall be deemed to mean any expenditure for a qualified purpose under section 1397E(d)(5).

(i) *Arbitrage investment restrictions—(1) In general.* Under section 1397E(g) and this paragraph (i), and except as otherwise provided in this paragraph (i), the arbitrage investment restrictions and rebate requirements under section 148 and §§ 1.148-1 through 1.148-11, inclusive, and the exceptions to those restrictions, apply broadly to gross proceeds of QZABs issued under section 1397E to the same extent and in the same manner as they apply to gross proceeds of tax-exempt state or local governmental bonds. For this purpose, references in those sections to tax-exempt bonds generally shall be deemed to refer to QZABs and, to the extent that any particular arbitrage restric-

tion depends on whether bonds are private activity bonds under section 141, the determination of whether QZABs are private activity bonds shall be based on the general definition of private activity bonds under section 141. In applying section 148 and the regulations under that section to QZABs, the modifications set forth in paragraphs (i)(2) through (i)(6) of this section shall apply.

(2) *5-year temporary period exception to arbitrage yield restriction.* If an issue of QZABs meets the requirements of section 1397E(f)(1) and paragraph (h)(2)(i) of this section, then the proceeds of the issue of QZABs are treated as qualifying for a 5-year temporary period exception to arbitrage yield restriction under § 1.148-2(e)(2) beginning on the issue date of the issue.

(3) *Disregard QZAB credit in QZAB yield for arbitrage purposes.* In determining the yield on an issue of QZABs for arbitrage purposes under § 1.148-4, the QZAB credit allowed under section 1397E(a) is disregarded.

(4) *Non-AMT tax-exempt bond investment exception inapplicable.* The exception to arbitrage yield restriction for investments of gross proceeds of tax-exempt bonds in specified tax-exempt bond investments not subject to section 148(b)(3)(B) (relating to an exception to the definition of “investment property” for specified tax-exempt bonds) and § 1.148-2(d)(2)(v) (relating to a corresponding exception to arbitrage yield limitations) is inapplicable.

(5) *Application of small issuer exception to the arbitrage rebate requirement.* Except as otherwise provided in paragraph (i)(6) of this section, for purposes of the small issuer exception to the arbitrage rebate requirement under section 148(f)(4)(D) and § 1.148-8, QZABs that are actually issued or reasonably expected to be issued by the QZAB issuer (and applicable entities aggregated under section 148(f)(4)(D)) within a calendar year are taken into account in measuring the applicable size limitation.

(6) *Certain defeasance escrow earnings.* With respect to a defeasance escrow established in a remedial action for an issue of QZABs that meets the special rebate requirement under paragraph (h)(8)(ii)(C)(2) of this section, the QZAB

issuer is treated as ineligible for the small issuer exception to arbitrage rebate under section 148(f)(4)(D) and paragraph (i)(5) of this section and compliance with that special rebate requirement is treated as satisfying applicable arbitrage investment restrictions under section 148 for that defeasance escrow.

(j) *Information reporting requirement.* Under section 1397E(h) and this paragraph (j), issuers of QZABs are required to submit information reporting returns to the IRS similar to the information reporting returns required to be submitted to the IRS under section 149(e) for tax-exempt state or local governmental bonds at the same time and in the same manner as those reports are required to be submitted to the IRS on such forms as shall be prescribed by the Commissioner for such purpose.

(k) *State or local government*—(1) *In general.* For purposes of section 1397E(d)(1)(B), the term *State or local government* means a State or political subdivision as defined for purposes of section 103(c).

(2) *On behalf of issuer.* A qualified zone academy bond may be issued on behalf of a State or local government under rules similar to those for determining whether a bond issued on behalf of a State or political subdivision constitutes an obligation of that State or political subdivision for purposes of section 103.

(l) *Cross-references.* See section 171 and the regulations thereunder for rules relating to amortizable bond premium. See § 1.61-7(d) for the seller's treatment of a bond sold between interest payment dates (credit allowance dates) and § 1.61-7(c) for the buyer's treatment of a bond purchased between interest payment dates (credit allowance dates).

(m) *Effective/applicability dates*—(1) *In general.* Except as otherwise provided in this paragraph (m), this section applies to bonds issued under section 1397E that are sold on or after September 14, 2007.

(2) *Special effective dates*—(i) *Effective dates for paragraphs (h)(2), (h)(3), (h)(4), (i), and (j) of this section in general.* Paragraphs (h)(2), (h)(3), (h)(4), (i), and (j) of this section apply to bonds issued

under section 1397E pursuant to allocations of the national qualified zone academy bond volume cap authority for calendar years after 2005 and sold on or after September 14, 2007.

(ii) *Permissive retroactive application*—(A) *In general.* Except as otherwise provided in this paragraph (m), issuers and taxpayers may apply this section in whole, but not in part, to bonds issued under section 1397E that are sold before September 14, 2007.

(B) *Special rule for certain provisions.* For purposes of the permissive retroactive application rule in paragraph (m)(2)(ii)(A) of this section, paragraphs (h)(2), (h)(3), (h)(4), (i), and (j) of this section need not be applied to any bonds issued under section 1397E to which those provisions do not otherwise apply under the general effective date provisions for those provisions in paragraph (m)(2)(i) of this section.

(C) *Definition of proceeds.* Issuers and taxpayers may apply paragraph (h) of this section, without regard to the definition of proceeds in paragraph (a)(2)(ii) of this section, to bonds issued under section 1397E that are sold before September 14, 2007.

(D) *Bonds issued before July 1, 1999.* Paragraphs (b) and (h)(10) of this section may not be applied to bonds issued under section 1397E that are issued before July 1, 1999.

(3) *Scope of reliance for bonds issued under sections 54A and 54E.* Except to the extent inconsistent with the successor statutory provisions for QZABs in sections 54A and 54E or applicable public administrative or regulatory guidance under those provisions and except as otherwise provided in this paragraph (m)(3), issuers and taxpayers may apply these regulations to QZABs issued under sections 54A and 54E that are sold after October 3, 2008. In the case of QZABs that are issued under sections 54A and 54E for which the issuer makes an irrevocable election under section 6431(f) to receive payments with respect to credits under section 6431, issuers and taxpayers may



not apply the remedial action provisions under paragraph (h)(8) of this section.

[T.D. 8755, 63 FR 673, Jan. 7, 1998; 63 FR 8528, Feb. 19, 1998, as amended by T.D. 8826, 64 FR 35574, July 1, 1999. Redesignated and amended by T.D. 8903, 65 FR 57733, Sept. 26, 2000; T.D. 9339, 72 FR 38774, July 16, 2007; T.D. 9495, 75 FR 44904, July 30, 2010; T.D. 9495, 75 FR 52267, Aug. 25, 2010]

#### RULES RELATING TO INDIVIDUALS' TITLE 11 CASES

SOURCE: Sections 1.1398-1 and 1.1398-2 appear at T.D. 8537, 59 FR 24937, May 13, 1994, unless otherwise noted.

#### § 1.1398-1 Treatment of passive activity losses and passive activity credits in individuals' title 11 cases.

(a) *Scope.* This section applies to cases under chapter 7 or chapter 11 of title 11 of the United States Code, but only if the debtor is an individual.

(b) *Definitions and rules of general application.* For purposes of this section—

(1) *Passive activity and former passive activity* have the meanings given in section 469 (c) and (f)(3);

(2) The unused passive activity loss (determined as of the first day of a taxable year) is the passive activity loss (as defined in section 469(d)(1)) that is disallowed under section 469 for the previous taxable year; and

(3) The unused passive activity credit (determined as of the first day of a taxable year) is the passive activity credit (as defined in section 469(d)(2)) that is disallowed under section 469 for the previous taxable year.

(c) *Estate succeeds to losses and credits upon commencement of case.* The bankruptcy estate (estate) succeeds to and takes into account, beginning with its first taxable year, the debtor's unused passive activity loss and unused passive activity credit (determined as of the first day of the debtor's taxable year in which the case commences).

(d) *Transfers from estate to debtor—(1) Transfer not treated as taxable event.* If, before the termination of the estate, the estate transfers an interest in a passive activity or former passive activity to the debtor (other than by sale or exchange), the transfer is not treated as a disposition for purposes of any provision of the Internal Revenue Code

assigning tax consequences to a disposition. The transfers to which this rule applies include transfers from the estate to the debtor of property that is exempt under section 522 of title 11 of the United States Code and abandonments of estate property to the debtor under section 554(a) of such title.

(2) *Treatment of passive activity loss and credit.* If, before the termination of the estate, the estate transfers an interest in a passive activity or former passive activity to the debtor (other than by sale or exchange)—

(i) The estate must allocate to the transferred interest, in accordance with § 1.469-1(f)(4), part or all of the estate's unused passive activity loss and unused passive activity credit (determined as of the first day of the estate's taxable year in which the transfer occurs); and

(ii) The debtor succeeds to and takes into account, beginning with the debtor's taxable year in which the transfer occurs, the unused passive activity loss and unused passive activity credit (or part thereof) allocated to the transferred interest.

(e) *Debtor succeeds to loss and credit of the estate upon its termination.* Upon termination of the estate, the debtor succeeds to and takes into account, beginning with the debtor's taxable year in which the termination occurs, the passive activity loss and passive activity credit disallowed under section 469 for the estate's last taxable year.

(f) *Effective date—(1) Cases commencing on or after November 9, 1992.* This section applies to cases commencing on or after November 9, 1992.

(2) *Cases commencing before November 9, 1992—(i) Election required.* This section applies to a case commencing before November 9, 1992, and terminating on or after that date if the debtor and the estate jointly elect its application in the manner prescribed in paragraph (f)(2)(v) of this section (the election). The caption "ELECTION PURSUANT TO § 1.1398-1" must be placed prominently on the first page of each of the debtor's returns that is affected by the election (other than returns for taxable years that begin after the termination of the estate) and on the first page of